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In the Supreme Court of the United States

OCTOBER TERM, 1984

WACO FINANCIAL, INC. AND J. JEROME PREVATTE,
PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

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QUESTION PRESENTED

Whether, in an enforcement proceeding brought to enjoin petitioners from engaging in the securities business, they may collaterally attack the constitutionality of prior disciplinary procedures where they failed to raise their challenge through the statutorily prescribed administrative and judicial review mechanism.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-6a) is reported at 751 F.2d 831. The opinion of the district court (C.A. App. 713-723) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on January 3, 1985. The petition for a writ of certiorari was filed on April 3, 1985. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner WACO Financial, Inc. (WACO) is a brokerage firm that formerly belonged to the National Association of Securities Dealers, Inc. (NASD), a national securities association registered with the Securities and Exchange

Commission (SEC) under Section 15A of the Securities Exchange Act of 1934, 15 U.S.C. 78*o*-3. Petitioner J. Jerome Prevatte is WACO's principal stockholder. They challenge the court of appeals' affirmance of an order of the district court enjoining them from engaging in the securities business so long as they are disqualified under Section 15(b)(7) of the Act, 15 U.S.C. 78*o*(b)(7). See Pet. App. 1a-2a.

Since obtaining NASD membership in 1978, WACO had frequently failed to comply with Commission rules, including those governing net capital and customer reserve accounts (C.A. App. 358-364).[1] In addition, WACO did not maintain its records with sufficient accuracy to allow it to calculate its required net capital or the proper balance for its customer reserve account (*id.* at 361-362). During an examination conducted in May and June 1980, for example, NASD investigators discovered that WACO's records had fallen into such disarray that the examiners had to devote an entire month to reconstructing them (*id.* at 362). See SEC Rule 17a-3, 17 C.F.R. 240.17a-3 (requiring broker-dealers to keep current records of certain transactions). Notwithstanding these efforts, an examination one month later revealed that WACO's records had again deteriorated to the point where necessary calculations could not accurately be performed (C.A. App. 363-364).

2. As a result of WACO's continued failure to maintain accurate records—along with other violations of rules and regulations promulgated by the NASD, the Commission, and the Federal Reserve System—the NASD District Business Conduct Committee (DBCC) for WACO's district

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[1]See SEC Rules 15c3-1, 15c3-3, 17 C.F.R. 240.15c3-1, 240.15c3-3. The net capital rule is one of the principal provisions designed to protect investors from undue financial risks when they entrust their funds to broker-dealers. See *Blaise D'Antoni & Associates* v. *SEC*, 290 F.2d 688 (5th Cir.), cert. denied, 368 U.S. 899 (1961).

issued complaints in 1980 against petitioners (C.A. App. 174-179, 185-190). After a hearing, the DBCC expelled WACO from the NASD and barred Prevatte from affiliating with any NASD member firm as a principal (*id.* at 364). Petitioners appealed to the NASD's Board of Governors, which affirmed in March 1981 (*id.* at 163-165). Pursuant to Section 19(d)(2) of the Act, 15 U.S.C. 78s(d)(2), petitioners applied to the Commission for review of the NASD's decision (Pet. App. 3a).

Petitioners sought unsuccessfully to obtain a stay of the NASD's determination pending Commission review.[2] The absence of a stay of their expulsion from the NASD disqualified petitioners, pursuant to Section 15(b)(7) of the Act, 15 U.S.C. 78*o*(b)(7) and Commission Rule 15b8-2, 17 C.F.R. 240.15b8-2 (1982), from engaging in the securities business. Petitioners failed to take available steps to suspend that disqualification.[3] They nevertheless remained in business, in violation of applicable statutory and regulatory requirements.

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[2]Petitioners' motion in the review proceeding to stay the NASD's decision was denied by the Commission. *In re WACO Financial, Inc.*, Admin. Proceeding File No. 3-6014 (May 4, 1981), stay denied, *sub nom. Waco Financial, Inc.* v. *SEC*, 665 F.2d 1047 (6th Cir. 1981) (Table).

[3]Under SEC Rule 15b8-2(b), 17 C.F.R. 240.15b8-2(b) (1982), WACO could have automatically suspended its disqualification by instituting a separate Commission proceeding for a determination that the public interest did not require disqualification. Despite being informed of this procedure by the Commission (see C.A. App. 137-138), petitioners failed to take advantage of it.

At the time that petitioners were disciplined by the NASD, a firm could be registered with the Commission as a broker-dealer even if it was not a member of the NASD. Such firms were known as "SECO" (SEC-Only) firms. Rule 15b8-2, however, prohibited a broker-dealer from engaging in business if it was expelled from the NASD for conduct inconsistent with just and equitable principles of trade. In 1983, Congress amended the Securities Exchange Act of 1934 to eliminate the SECO program and to prohibit broker-dealers from engaging in the securities business unless they are registered with a national securities association or they effect transactions exclusively on a national securities exchange. Act of June 6, 1983, § 3, Pub. L. No. 98-38, 97 Stat. 206.

Petitioners chose not to pursue their application for Commission review of the sanctions entered by the NASD. Following petitioners' failure to file a brief or other statement on the merits after having been granted two 30-day extensions, the Commission dismissed the review proceeding on July 23, 1981. Pet. App. 3a-4a. Petitioners did not seek judicial review of this order.

3. While the application for Commission review was still pending, the Commission filed this enforcement action in the United States District Court for the Western District of Michigan to enjoin petitioners from engaging in the securities business in violation of Section 15(b)(7) of the Act, 15 U.S.C. 78*o*(b)(7), and SEC Rule 15b8-2, 17 C.F.R. 240.15b8-2 (1982). The district court entered a preliminary injunction against petitioners. 518 F. Supp. 651 (1981). Following discovery intended to support petitioners' claim that the NASD's decision resulted from procedures that violated the Due Process Clause, the district court entered summary judgment in the Commission's favor, finding that no due process violation had occurred (C.A. App. 713-723). The court permanently enjoined petitioners from conducting further securities business in violation of Section 15(b)(7) of the Act (*id.* at 724, 725-727).

The court of appeals affirmed (Pet. App. 1a-6a). The court reasoned that petitioners' failure to pursue their administrative and judicial remedies under the Act foreclosed their collateral attack on the NASD proceedings here (*id.* at 5a-6a). The court did not reach the merits of petitioners' constitutional claims.

In the wake of the amendments, which had the effect of codifying the automatic disqualification provisions of Rule 15b8-2, the Commission rescinded the rule as superfluous. 48 Fed. Reg. 53688 (1983).

ARGUMENT

The court of appeals correctly held that petitioners cannot collaterally attack the fairness of the NASD's procedures after they failed to pursue the statutorily prescribed mechanism for obtaining direct administrative and judicial review of the NASD's disciplinary action. The court's ruling fully comports with the decisions of this Court and the other courts of appeals. Further review is therefore unwarranted.[4]

1. Congress's scheme for regulating broker-dealers establishes cooperative private and governmental responsibility for regulation of the industry. See S. Rep. 94-75, 94th Cong., 1st Sess. 22 (1975). As part of this scheme, the Securities Exchange Act of 1934 confers certain disciplinary authority on registered national securities associations, subject to Commission oversight. See, *e.g.*, Sections 15A(b)(7), 19(d)(2) of the Act, 15 U.S.C. 78*o*-3(b)(7), 78s(d)(2); *United States* v. *NASD*, 422 U.S. 694, 700-701 n.6 (1975).[5] The Act requires national securities associations to employ fair procedures in exercising their disciplinary authority (Section 15A(b)(8) and (h)(1), 15 U.S.C. 78*o*-3(b)(8) and (h)(1)). Upon application for review, the Commission is required by the Act to conduct an independent review of the record and to determine de novo whether a violation has been established (Section 19(e)(1), 15 U.S.C. 78s(e)(1)). The aggrieved party may then seek review in the court of appeals (Section 25(a)(1), 15 U.S.C. 78y(a)(1)). The Act bars judicial review of matters not urged before the Commission (Section 25(c)(1), 15 U.S.C. 78y(c)(1)).

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[4]Petitioners have also sought review by this Court of the court of appeals' denial, in a separate action, of a writ of mandamus seeking the disqualification of the district judge presiding in a damages action that they have filed challenging the NASD's actions. *Prevatte* v. *Gibson*, No. 84-1826. The Commission is not a party to that action.

[5]The NASD is the only national securities association registered with the Commission.

The statutory scheme provided by Congress for review of NASD and Commission decisions is exclusive. As the Court stated in *Whitney National Bank* v. *Bank of New Orleans & Trust Co.*, 379 U.S. 411, 420 (1965), "where Congress has provided statutory review procedures designed to permit agency expertise to be brought to bear on particular problems, those procedures are to be exclusive." See also, *e.g.*, *Gaunce* v. *de Vincentis*, 708 F.2d 1290, 1292 (7th Cir.), appeal dismissed, 464 U.S. 978 (1983); *Robinson* v. *Dow*, 522 F.2d 855, 858 (6th Cir. 1975). Exclusivity is particularly appropriate here, where the prescribed de novo review by the Commission ordinarily would cure any defect in the earlier proceedings before the NASD. Petitioners' attempt to evade the statutory process would foreclose the Commission from applying its expertise to the circumstances giving rise to their disqualification.

Established principles of administrative law, as well as Congress's intent in setting forth a mechanism for review in the Act, dictate that petitioners not be permitted to raise a claim for which they failed to exhaust their administrative remedies. See generally *McGee* v. *United States*, 402 U.S. 479, 483-485 (1971); *McKart* v. *United States*, 395 U.S. 185, 193-195 (1969); *Myers* v. *Bethlehem Steel Corp.*, 303 U.S. 41, 50-51 (1938); see also *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *NASD*, 616 F.2d 1363, 1370 (5th Cir. 1980) (exhaustion doctrine applies to NASD disciplinary proceedings); *First Jersey Securities, Inc.* v. *Bergen*, 605 F.2d 690, 694-695 (3d Cir. 1979) (same). Having deliberately bypassed their administrative remedy,[6] petitioners

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[6]Petitioners were well aware of the need to press their claims before the Commission in the first instance. As early as April 1981—nearly three months before the Commission dismissed petitioners' application for review—the district court in a separate proceeding had denied their attempt to stay the NASD sanctions because of their failure to exhaust, thereby alerting them to the importance of utilizing their administrative forum. *WACO Financial, Inc.* v. *NASD*, 513 F. Supp. 758, 760-761 (W.D. Mich.). When the court of appeals denied petitioners' request for a stay in July 1981, the Commission still had not dismissed the application for review.

are not now entitled to raise their arguments in this enforcement proceeding. See *McGee*, 402 U.S. at 484-488 (defense of conscientious objector status could not be adjudicated for first time in criminal prosecution). The court of appeals' application of settled law to the facts of this case merits no further review.[7]

Petitioners contend (Pet. 26-30) that their constitutional claims are not subject to the exhaustion requirement because they cannot be adjudicated by the Commission. But "[t]he bare contention of lack of due process does not operate to relieve [petitioners] from the requirement that [they] exhaust administrative remedies." *SEC* v. *R.A. Holman & Co.*, 323 F.2d 284, 288 (D.C. Cir.) (Burger, J.), cert. denied, 375 U.S. 943 (1963). Given the availability of ultimate judicial review (see page 5, *supra*), there is no justification for allowing petitioners to escape the exhaustion requirement merely because they raise a constitutional claim. See generally *Aircraft & Diesel Equipment Corp.* v. *Hirsh*, 331 U.S. 752, 772-774 (1947); *Gaunce* v. *de Vincentis*, 708 F.2d at 1293 ("[s]o long as effective means for judicial review are ultimately available where the constitutional claims can be raised, [petitioners] may not dispense with the requirement of prior administrative review"). This is especially so here, where the issues that petitioners raise, such as bias and commingling of functions, are best addressed by the courts through review of final agency action on a complete record. See *Touche Ross & Co.* v.

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[7]Petitioners' reliance (Pet. 28) on *Lichter* v. *United States*, 334 U.S. 742 (1948), is wholly misplaced. Far from supporting their assertion that the exhaustion doctrine does not apply in enforcement proceedings, *Lichter* holds (*id.* at 792) that exhaustion is required in tax collection cases. Whether facial constitutional challenges to a statute require exhaustion (see *id.* at 774) is irrelevant to the question presented here.

SEC, 609 F.2d 570, 575 (2d Cir. 1979); *First Jersey Securities, Inc.* v. *Bergen*, 605 F.2d at 699.[8]

2. The bulk of the petition (pages 14-26) is devoted to petitioners' attack on the constitutionality of the NASD's disciplinary procedures.[9] Because the court of appeals did not reach this issue, review is unwarranted. See, *e.g.*, *Davis* v. *Passman*, 442 U.S. 228, 249 (1979). In any event, petitioners' allegations are meritless. The NASD's hearing procedures have consistently withstood challenge under the Due Process Clause. See *Sorrell* v. *SEC*, 679 F.2d 1323, 1326 (9th Cir. 1982); *First Jersey Securities, Inc.* v. *Bergen*, 605 F.2d at 697-700; *Todd & Co.* v. *SEC*, 557 F.2d 1008, 1012-1013 (3d Cir. 1977); cf. *Shultz* v. *SEC*, 614 F.2d 561, 569 (7th Cir. 1980) (Chicago Board Options Exchange); *Allan* v. *SEC*, 577 F.2d 388, 392 (7th Cir. 1978) (New York Stock Exchange).

Petititioners have failed to demonstrate either actual or probable bias flowing from the ex parte communications and commingling of functions of which they complain. The

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[8]The court of appeals correctly distinguished (Pet. App. 5a) *Califano* v. *Sanders*, 430 U.S. 99 (1977), and *Johnson* v. *Robison*, 415 U.S. 361 (1974), on which petitioners rely (Pet. 27). *Sanders* concerned the availability of judicial review, not the exhaustion requirement. Here, of course, judicial review would have been available had petitioners pursued their administrative remedy (see page 5, *supra*). *Johnson* similarly concerned the availability of judicial review; the Court's reference (415 U.S. at 368) to the principle that agencies may not generally adjudicate the constitutionality of the statutes under which they operate has no application here, where petitioners have not called into question the constitutionality of the statutory scheme.

[9]Petitioners' challenge (Pet. 30-35) to the district court's discretionary ruling that they could reopen a deposition only at their own expense obviously does not merit review by this Court. In any event, the discovery related only to the merits of petitioners' constitutional claims, consideration of which is foreclosed by their failure to exhaust administrative remedies.

ministerial tasks performed by NASD staff members hardly suffice to show that the DBCC hearing panel was biased against petitioners. See generally *Withrow* v. *Larkin*, 421 U.S. 35, 47 (1975); *Richardson* v. *Perales*, 402 U.S. 389, 408-410 (1971); *PATCO* v. *FLRA*, 685 F.2d 547, 564-565 & nn.33-36 (D.C. Cir. 1982); *Shultz* v. *SEC*, 614 F.2d at 569. Nor was there any evidence supporting petitioners' claim that the DBCC panel members were improperly selected. Rather, the record shows that members were chosen by the chairperson of the full DBCC, not by the prosecuting staff member (see C.A. App. 622-623).[10]

Finally, petitioners' assertion (Pet. 24-26) that they were improperly judged in light of the DBCC members' subjective experiences rather than objective legal standards lacks substance. Petitioners were charged with violations of specific regulatory provisions adopted by the Commission, the NASD, and the Federal Reserve System (C.A. App. 174-177, 185-187). The written decisions of the DBCC and the NASD Board of Governors explained in meticulous detail precisely the provisions that petitioners had violated (*id.* at 163-165, 354-364).[11]

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[10]Petitioners quote (Pet. 9 n.6) the testimony of one panel member, Theodore Perkowski, that he was "always getting called" to support their assertion that members biased in favor of the prosecution were primarily called for service. Petitioners take this quotation out of context. In response to a question whether he knew if the first three DBCC members who were called were always chosen for the hearing panel, Perkowski replied (C.A. App. 603), "I don't know, because I never call them. I am always getting called."

[11]In arguing that the DBCC panel judged them by subjective standards, petitioners again torture the plain meaning of Perkowski's testimony (see Pet. 23-24). He testified (C.A. App. 605) that the hearing panel tries to "go by the letter of the rules." His discussion of "subjective experiences" plainly signifies only that he evaluated the alleged violations of NASD rules in light of his experience in the brokerage industry (see *id.* at 569, 604-605). This is precisely what the scheme of self-regulation requires NASD decisionmakers to do. See *First Jersey Securities, Inc.* v. *Bergen*, 605 F.2d at 698.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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